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SUBJECT: MALAWI'S BUDGET CONSULTATIONS

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SUMMARY

1. (U) In preliminary budget consultations with donors, Finance Minister Goodall Gondwe sketched an FY 2005/06 budget that would include some tax reform, allocations for humanitarian food relief, and a comparatively modest fertilizer subsidy. The budget for development will be increased by 35 percent, largely to be spent on road maintenance and reforestation. While Gondwe offered no numbers, Malawian news media report a total budget of MK113 billion (\$1 billion), a 10 percent increase in real terms over the previous year. It remains to be seen whether the increase will deliver better government. End summary.

TAX REFORM IN 2005/06

2. (SBU) Gondwe opened his briefing with an overview of the tax reforms being considered by the Ministry. As part of the legislative package to be presented to Parliament at the end of May, Gondwe will propose tax reforms with three aims: greater fairness to instill confidence for investors, enhanced transparency, and a more efficient organization for the Malawi Revenue Authority. The changes will include removal of discretionary exemptions, changes to ensure timely VAT refunds, some small changes to individual income tax levels, and greater emphasis on tax collection from non-compliant businesses and individuals. Several times during the briefing, Gondwe went out of his way to praise the U.S. Treasury's assessment work, which he said had given much more useful insight and advice than other technical assistance teams (including IMF).

FOOD AND FERTILIZER

3. (U) The budget will likely include funding to import 12,000 metric tons of maize for humanitarian relief and 30,000 MT for commercial sale (about half last year's commercial buy). Donors are expected to donate funds for 78,000 MT of humanitarian grain, on top of 60,000 MT already sourced to top up the strategic grain reserves. Total humanitarian supplies should be 150,000 MT, nearly all donor funded. As reported previously, the exact extent of the need depends on reports due in late May.

4. (U) On the ever-controversial topic of fertilizer subsidies, Gondwe said that the GOM would not continue previous years' targeted input program of free seed and fertilizer to smallholders, which has been largely underwritten by the UK. Based on the poor results of last year's program, the GOM and UK have agreed to drop the program. Having no fertilizer subsidy is politically difficult, so the GOM plans to introduce a subsidy only on the specific fertilizers used for maize, available for one bag (either 25 or 50 kg) per farmer. Gondwe presented this as a cheaper, quasi-self-targeting alternative to the TIP and the universal fertilizer subsidies of the past. He estimated the cost to be MK1.5 - 2 billion (\$13-18 million).

INHERITED PROBLEMS; NEW DONOR MONEY FUNDS NEW GROWTH EFFORT

5. (U) Outlining his main concerns, Gondwe listed several familiar problems: a domestic debt stock of MK60 billion (\$530 million), inherited arrears of MK10.5 billion (\$92

million), and increased government wages (implemented in 2004 to satisfy World Bank and IMF conditionalities). While Gondwe hopes to retire a modest amount of debt, he is clearly frustrated by the fact that donor budget support precludes running the large surplus necessary to retire a major portion of the debt. Another looming concern is the need for government pension reform. Gondwe hopes to introduce an employee contribution scheme this year, administered from outside the government, with a retirement age of 60 rather than the current 55.

16. (U) Gondwe has so far offered no numbers, but unofficial reports show a total budget of MK113 billion (\$1 billion), of which MK65 billion is funded from GOM revenues and MK45 billion from donors, with a deficit of MK3 billion. Most of the increase (from MK91 billion in 2004/05) would be from resumption of normal donor inflows after a new IMF program begins around mid-year. As far as spending goes, Gondwe intends to grow the development budget from MK23 billion to MK31 billion, consistent with the President's emphasis on economic growth over social spending. Much of the increase would be put into road maintenance and reforestation in critical watersheds. Gondwe has indicated in other conversations that he will likely cut back on education spending until he is convinced that the education ministry can improve its performance.

COMMENT: CONTINUED PROGRESS, IF IT ALL FOOTS

17. (SBU) The numbers will tell the tale, but from early indications, it appears that Gondwe is still going in the right direction. If donor contributions tick up as expected, the GOM will have more to spend, and the preliminary overview suggests that it is focused as strongly as ever on not overspending. This is a welcome change. Still, while the macro-level discipline is there, the ministries have yet to show that they can get anything done with the money they get. The next test is whether the Mutharika administration, given a bit more resources, can deliver better government.
GILMOUR